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### U.S. NATIONAL OUTLOOK

#### Overview: Shaken and Stirred

*“Winter is Coming”*

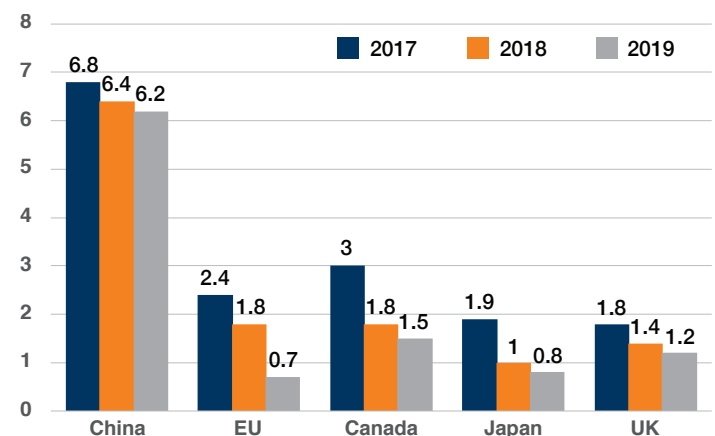
— House Stark motto, *Game of Thrones*

The most widely acclaimed and beloved show of our time, the epic fantasy drama *Game of Thrones*, and the U.S. economy appear to bear some eerie similarities as of late. In the fantasy world of Westeros, summers and winters are arbitrary and erratic, lasting years and even generations. Indeed, at the start of the hit series, viewers learned that the world had been experiencing an unusually long summer, going on 10 years. But happy tales are not its staple, so the series begins with an ominous iconic quote: “Winter is Coming.” It is a sobering reminder that darker times are lurking around the corner, that the Long Night may descend soon, and that long summers are accompanied by even longer winters.

“Winter is Coming” is an apt description of the start of 2019 for the global economy. A dour mood seems to have settled everywhere. Eurozone inflation sagged to a two-year low and its manufacturing sector sank to its lowest level in six years, providing fresh evidence that the single-market economy is perched precariously close to a recession. The main drag came from Germany, which has experienced a near-collapse of its manufacturing sector (the worst showing since February 2012), stung by slowing global growth and declining demand for its exports. The Chinese economy grew by 6.4% at the end of 2018, its lowest rate in 28 years, and officials are expecting growth to be around 6.2% in 2019, a remarkable downshift from the 7-8% growth posted just a few years ago. Growth in other economies has also softened considerably: in Japan, it has dropped from 1.9% in 2017 to 1% in 2018; in Canada, it has slowed from 3% in 2017 to 1.8% in 2018; in the UK, it decelerated from 1.8% to 1.4%

(Figure 1). The much vaunted “synchronized upswing” of 2017 became a “coordinated downshift” in 2018, assuming a seriously more ominous undertone at the start of 2019.

**FIGURE 1**  
**From Synchronized Upswing ... to Synchronized Slowdown**  
(Real GDP Growth, Annualized Percent Change)



The U.S. economy has not remained unscathed by these woes. The current expansion celebrates its 10th birthday this June, a period of time that is inauspiciously as long as the summer season at the start of the *Game of Thrones* series. Fantasy world aside, there are valid reasons to fret, not so much perhaps about the length of the expansion, but rather about the stage of the cycle (early, mid or late), which is much more telling when determining the lifespan of expansions. The fourth quarter of 2018 turned out to be utterly abysmal for stocks and sentiment: The S&P500 swooned by 19.8% (barely avoiding the 20% correction threshold) and business sentiment turned sour.

It did not help that hard data at the end of 2018 and early 2019 reinforced the gloomy outlook: Retail sales collapsed by 1.6% in December, posting the biggest drop in more than nine years;

vehicle sales declined for two consecutive months, averaging 17 million, down from 17.7 in 2018; housing construction and home sales flat-lined; new orders on nondefense capital goods (a barometer for business investments) fell 0.1% in February, while durable goods orders collapsed by 1.6%. Even the labor market, which has been white hot for quite some time, came to a standstill in February adding a paltry 33,000 jobs (after a staggering 311,000 in January), while household wealth took a nosedive to the tune of \$3.7 trillion in the fourth quarter as equity markets collapsed. Real GDP growth for the fourth quarter was revised down to 2.2% from an initial estimate of 2.6%, which was released with some delay due to the government shutdown.

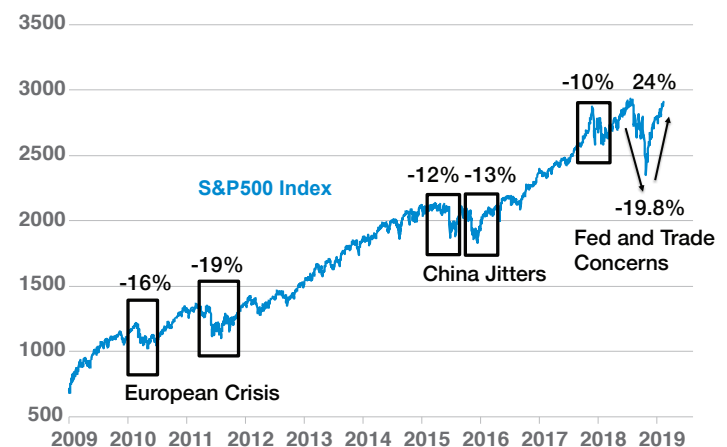
The drumbeat of depressing news drove the 10-year yield below the 3-month rate in March, inverting the yield curve for the first time since 2007 – an event that has preceded every recession since WWII. It came on the heels of a remarkable dovish Fed outlook in its March meeting, when a trifecta of policy news, rarely seen in policy announcements, was released: a dramatic downshift in economic outlook, a pause in interest rate hikes in 2019, and an end to the unwinding of its balance sheet by September of this year. This rattled markets and frayed confidence: According to the survey of forecasters compiled by the Philadelphia Fed, fears of a recession spiked to levels last seen in 2008, at the height of the financial crisis. Nearly 84% of the economists surveyed by the *Wall Street Journal* saw risks to the outlook tilted to the downside in 2019 and more than half (57%) expected a recession to start in 2020. There is little doubt that in a *Game of Thrones* world, the first quarter of 2019 would have been the perfect time for the *Citadel* to send the white ravens around the world, signifying that “Winter is Here.”

While talent for imagining the worst is valuable (and something we possess in abundance), our view is that recession fears at this point are overblown even as growth is set to decelerate from last year's path. Winter may be coming, but it is not here thus far, and the long summer has yet to run its course. However, this outlook hinges a great deal on the assumption that policy mistakes are avoided: The Fed carefully and successfully navigates the existing dangerous crosscurrents, the U.S.-China trade dispute is resolved quickly, a hard Brexit is avoided and the rest of the world (particularly the Eurozone) acts swiftly to forestall a worse outcome.

There are good reasons to believe that the rest of the year will shake off some of the gloom that descended at the end of 2018 and continued in the first quarter. To start with, the very latest data has taken some of the edge off recession fears: manufacturing activity in both the U.S. and China seems to have perked up and is shaping up to be better than feared;

retail sales for January were revised upward (by almost three times the initially reported amount); business inventories rose more than expected, and construction spending (both private and public) rose 1% in February after being upwardly revised (quite substantially) for both January and December. Wage growth has firmed up to 3.3%, the highest so far in this cycle, and the four-week unemployment claims are back down below the 220,000 level, suggesting further strength in the labor market. The University of Michigan consumer sentiment rose to its highest level since October, after deteriorating for five straight months. The thaw in sentiment has lifted the much-feared yield curve out of inversion territory, where it dawdled for just over one week. The stock market posted a blockbuster first quarter, rising by 13.1%, the best first quarter of any year since 1998 (Figure 2). The Atlanta Fed nowcast model, which tracks GDP in real time using a high frequency model, has upgraded its forecast for first quarter GDP from a measly 0.2% in mid-March, to a much more solid 2.8%.

**FIGURE 2**  
**Turbulent Equity Markets: A Near 20% Drop**  
**...Followed by the Best Quarter in Over 10 Years**



The policy environment has also improved dramatically. The Fed has swung from a position of excessive hawkishness (three rate hikes in 2019 and a balance sheet unwinding that is on autopilot) to one of extreme patience and flexibility (no rate hikes this year and an end to the quantitative tightening by October). The dramatic u-turn is as close as we will get to the Fed's admission that the December rate hike was indeed a mistake. Elsewhere, news also appears to be more upbeat: The U.S.-China trade negotiations are moving along, though some of the thornier issues (such as enforcement, intellectual property issues, digital trade and removal of current tariffs) are still unsettled. The Chinese economy appears to be a touch better than earlier this year, as manufacturing revives and growth

stabilizes, aided by a large dollop of fiscal and monetary support (a drop of 350 bp in required deposit reserve ratio, a tax cut of around 1.5% of GDP and fiscal stimulus of 0.6% of GDP). Fiscal policy should also boost U.S. GDP growth, at least through the end of this fiscal year. Last year's budget agreement lifted spending caps and authorized higher discretionary spending, but actual spending has come in well shy of the sanctioned amounts in large part due to the prolonged government shutdown. Now that the shutdown is over, we expect a pickup in federal spending through the end of the third quarter.

These more upbeat developments should not be mistaken for a return to the robust growth of last year. Indeed, our outlook is for growth to decelerate this year and the next, all the while avoiding a headlong plunge into recession territory. Signs of an impending downshift in economic activity are virtually everywhere. The service PMI index, while still solidly in expansion territory, fell in March, indicating that the soft patch in the economy has also spread to this sector. The labor market is also expected to moderate, after having posted sizable gains over the past four years. Fiscal policy will turn more restrictive as the effects of the tax cuts wane and the current spending agreement runs out at the end of the fiscal year. Corporate profits are coming under significant pressure due to higher wages and energy costs, while earnings are estimated to decline by 3.4% in the first quarter. Indeed, an earnings recession cannot be entirely ruled out at this point. The grounding of Boeing's 737-Max aircraft means that durable goods orders will be under added pressure over the next few months and likely present downside risk for equipment spending. Even the housing sector, which we expect will lift itself out of the funk of the past year thanks to lower mortgage rates, is unlikely to experience a breakout year. In case you were wondering, this is what a late cycle expansion looks like. Welcome to late summer in Westeros!

But slow growth does not mean an impending recession. With the exception of the yield curve and the excessively low unemployment rate (suggesting tightness in the labor market), none of the other leading indicators are flashing warning signs. The last few cycles have shown that expansions tend to come to an end either because of overheating or because of financial imbalances, neither of which appear threatening at the moment. This expansion will likely keel over one day, but not this year or the next. In the immortal words of the "Game of Thrones":

"What do we say to the God of death?"  
"Not today!"

## Keeping Winter at Bay: Recession Not in the Cards for Now

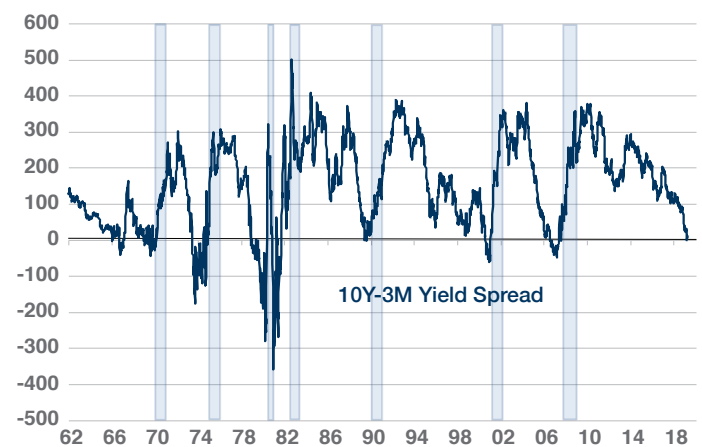
*"Valar Morghulis" (All Men Must Die)*

*"Valar Dohaeris" (All Men Must Serve)*

*-Game of Thrones*

This expansion will certainly meet its maker one day (*Valar Morghulis – All Men Must Die*) but not before it runs (serves) its natural course (*Valar Dohaeris – All Men Must Serve*). And as of now, signs are that its life won't be snuffed out soon, at least not over the next 18 months. Take for example, the much feared yield curve inversion, which has been a reliable indicator of an impending recession in all post-war cycles (Figure 3). Even here things appear less ominous than originally feared. First, the curve has reverted back in positive territory. Second, in all the previous cycles, the inversion lasted a relatively long time (a matter of months, not days) and the incursion in negative territory was much deeper. For example, the spread between the 10-year note over the three-month bill fell as much as -60 basis points in early 2007 and remained in negative territory for a full 10 months. During the previous cycle, the curve inverted eight months before the start of the recession in March 2001, and the yield spread fell to nearly -100 bps in late 2000. Moreover, an inversion does not mean an imminent recession: On average, a yield curve inversion has signaled a recession roughly 15-18 months down the line (the shortest time was eight months in 1970 and the longest 20 months in the late 1960s).

**FIGURE 3**  
Yield Curve Has Predicted Every Recession in Post War Era  
(10-year-3-Month Yield Spread, Basis Points, Recession Bars)



It should also be noted that the yield curve is not utterly infallible. An inversion occurred in 1966 when a slowdown, but not a recession, followed, and also briefly in 1998 on the heels of the LTCM collapse. Moreover, its reliability is especially suspect now, after the many rounds of quantitative easing. On average, the \$1.5 trillion of QE purchases of Treasury securities are estimated to have suppressed long term yields by around 60 basis points. And even though \$300 billion of Treasury securities have rolled off the Fed's balance sheet somewhat reversing the effect of quantitative easing, long-year yields are arguably still below where they ought to be absent this intervention.

On the face of it, these arguments may appear to be a bit too dismissive of the predictive power of the yield curve. This is not our intent: the yield curve is signaling something – a slowdown and an elevated probability of a recession, but not, in our view, an imminent recession. The Fed can certainly breathe new life into this expansion, if after pausing the rate hiking cycle it follows with a rate cut. There is precedent for cutting rates in the midst of an expansion: In the mid-1990s (when the yield curve was flat) and in 1966 (when the yield curve inverted), a recession was avoided by the rapid response of the Fed in the form of rate cuts.

Moreover, the yield curve should be viewed as a powerful leading indicator among a mosaic of many others. At present, other leading indicators, though weakened, are not flashing warning signs. Take, for example, the labor market, which is one of the measures used to determine the onset of a recession: Back-to-back declines in employment are a sign that recession is imminent (or has already commenced). However, it is a coincident indicator and not a leading one. Nonetheless, employment does not turn overnight: Before an outright drop, the pace of job formation typically slows with a lead of roughly one year. We see no signs of this occurring: The temporary services sector (a leading indicator of employment by 4-6 months) has grown at a steady 2-2.5% pace over the past few months, and even though the momentum has ebbed a bit as of late, we would need to see an outright decline to the tune of -2% to -3% before we become overly concerned. Initial unemployment claims, which are released on a much higher-frequency (weekly) basis, have resumed their downward trend, averaging 217,000, far below the 280,000-290,000 level consistent with businesses pulling back from hiring.

Other indicators, though moderating, are not signaling elevated risks. Consumer sentiment, which precedes recessions by five to 10 months, has cooled from a cycle-high of 136 to a current 124 – a twelve-point decline, according to the Conference Board. Historically, a fall of around 30 points

has signaled a recession. More encouragingly, the Michigan Sentiment index signaled a firming in March, which means that consumers may be shaking off the winter blues. Housing permits commonly lead a recession by around 10-12 months, and though they have declined over the past couple of months at an annualized rate of around -2%, this is a far cry from the -20% drop that generally precedes recessions. We do expect modest improvement in residential and nonresidential construction this year, so we don't anticipate this indicator to turn further south. The Purchasing Managers Manufacturing Index, another bellwether of economic conditions (which leads the economy by three to six months), continues to remain firmly in expansion territory (above the 50-mark), though it has weakened relative to levels seen six months ago. And though the net percentage of banks tightening standards for C&I loans (which leads a recession by roughly around five months) turned positive for the first time in three years (at 2.3%), indicating tighter financial conditions, this is still far below the threshold of 20%, which is commonly associated with a recession.

Broadly speaking, there are two main factors that have commonly brought on the demise of an expansion in the post-war era: overheating (inflationary pressures), which have led to aggressive rate hikes, or financial imbalances (followed by asset price crashes). The last three cycles have fallen mostly in the second category (Table 1). But neither of these appear to be threatening at the moment.

**TABLE 1**  
Key Causes of U.S. Recessions

	Overheating/ Fed Tightening	Financial Imbalances
Aug-57		
Apr-60		
Dec-69		
Nov-73		
Jan-80		
Jul-81		
Jul-90		
Mar-01		
Dec-07		

Start with overheating. Inflation has remained strangely quiescent even though the recovery is closing in on 10 years. Every time inflationary pressures started to build (such as in mid-2018), they dissolved just as quickly: PCE inflation (the Fed's preferred measure) rose to 2.4% last summer only to sag down to 1.4% in January. Core PCE inflation has also weakened

to 1.8% from an average of 2% in 2018. This has happened despite the fact that the labor market has tightened considerably, delivering the lowest unemployment rate in nearly a generation.

There are reasons as to why inflation has not ticked up despite decade-low unemployment rates. For one, wage growth has only recently picked up, and even so, at 3.2% annualized pace, it remains quite subdued. In addition, corporations have been loath to raise prices, having had enough cushion to absorb wage growth thanks to strong profits buoyed by last year's corporate tax cuts. Moreover, though by some metrics (such as the unemployment rate), the labor market appears to be tight, not all slack appears to have been mopped up. One underappreciated measure of slack is the shorter workweek: The numbers of hours worked per week are roughly 0.4 below the 2004-2007 cycle and a full 0.7 hours below the 1990s expansion. More importantly, the labor force participation rate for prime-age workers remains around 1.8 points below pre-crisis levels. This translates to around 3 million sidelined workers, suggesting that the capacity of labor force expansion may have not been fully exhausted, at least not yet. And since the Fed has signaled a pause in the rate-hiking cycle (in large part due to weakness in inflation), the overheating scenario is not as menacing as it seemed last summer.

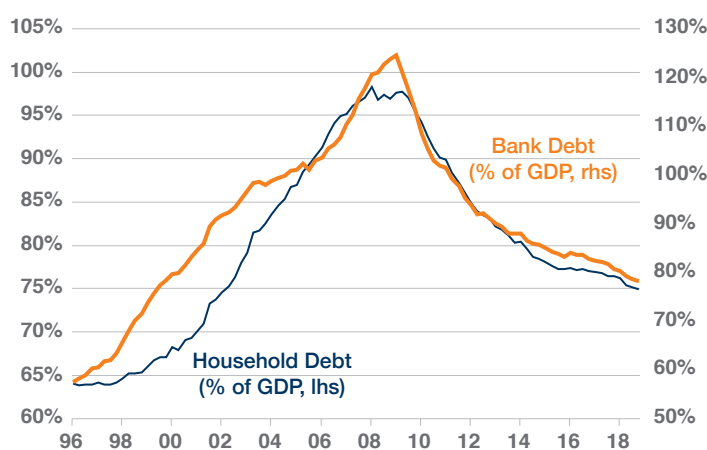
Financial imbalances, the death knell of the last three expansions, though building up in some corners of the economy, do not appear threatening either. Though total consumer debt rose to an all-time high of \$13.5 trillion in the fourth quarter of 2018, as a share of GDP, the debt has collapsed from a high of 98% (in the first quarter of 2008) to 75%, a level similar to the late 1990s and early 2000s (Figure 4). The debt composition has also shifted

dramatically, with mortgages making up only 67% of total debt, down from the 74% registered at the height of the housing boom. Even more encouragingly, 58% of mortgage loans originated last year went to borrowers with pristine credit scores (as opposed to only 36% back in 2008). Consumers are also saving more: The saving rate ticked up to above 7.5% at the end of last year, as households hunkered down and squirreled away funds amid a mountain of dour news and equity market turmoil. Household debt service and financial obligations are at their lowest in more than four decades, homeownership rates have corrected back to their historical average, and spending on business fixed investments and consumer durables – a good barometer of an overstretched economy – is still below its historical average.

There are even some improvements. Some pockets that appeared frothy a few years ago, such as auto loans, are looking better at present. First, the pace of credit has decelerated significantly, from a torrid double-digit rate of a couple years ago, to a current annualized rate of 3%. The share of subprime auto loans has also stabilized, dropping from an eye-popping 23% to a current 18%. More importantly, the subprime auto loan debt, at just \$285 billion, represents only 2% of household debt, far below the 10% (\$1 trillion) subprime mortgage debt which brought the economy to its knees during the financial crisis. On the other hand, student debt has continued to rise to a jaw-dropping \$1.5 trillion and delinquencies are high. But since this debt is federally guaranteed, student debt is unlikely to trigger a financial crisis. Its impact, however, is on higher debt burdens for the young, which will weigh on economic growth over many years.

As we cautioned in the past, while household and financial sector debt appear manageable, vulnerabilities are rising in the corporate sector. Leveraged loans (which involve highly indebted companies with weak credit profiles) have ballooned from a mere \$20 billion around 20 years ago to a current \$1.4 trillion. But even here, the outlook is not as bleak as a few months ago: The pace of leverage loan growth decelerated markedly at the end of 2018, with the momentum gaining further strength early this year, when outstanding new volumes collapsed by 56%. To be fair, this was part of a broader trend: syndicated lending overall fell by 36%, reflecting tighter financial conditions early in the year. But the fact that it was more pronounced for the leveraged market seems to indicate that some type of correction may be underway. While this market bears continued monitoring, we are a tad less concerned now than we were in our last report.

**FIGURE 4**  
Households and the Financial Sector Have Deleveraged Rapidly  
(Debt, Percent of GDP)





## The Long Summer: A Soft Landing – Slow but Continued Growth

### Real GDP

While the economy is not skidding towards a recession, the age of this expansion is beginning to show and growth is expected to moderate somewhat this year and the next compared to 2018. Momentum started to ebb at the end of 2018 and spilled over into this year. Fourth quarter data came with some delay due to the government shutdown and when it did, the first estimate was revised down from 2.6% to a current 2.2%. Despite fourth quarter woes, overall growth for 2018 came in at a solid 2.9%, same as in 2015, making both these years the strongest in an expansion closing in on 10 years.

The first quarter of this year is shaping up better than originally feared, but not on par with last year's growth. Indeed, virtually all indicators are signaling that momentum has ebbed and growth has taken a step back from 2018. Table 2 summarizes this: If over the past three months the data have improved compared to the 12-month moving average, the cell is green, if the three-month trend is the same as in the past 12 months, the cell is colored in yellow, and if momentum has weakened the cell is marked in red. There is a sea of red as far as the eye can see in the latest data. In addition, a number of other temporary factors will likely weigh on growth in the first quarter: the temporary government shutdown (which likely will lop off around 0.3 percentage points from growth), residual seasonality (a first-quarter quirk in the data during this expansion) and slower initial tax refunds. On the plus side, inventories appear poised to give a much needed lift to U.S. GDP in the first quarter.

We do expect growth to pick up for the remainder of the year, though at a lower gear than in 2018. Fiscal policy will likely add to growth in the second and third quarters, though not as much as in 2018 when the tax cut (and the new spending caps) juiced up growth. The pause in interest rate hikes ought to ease financial stress and temper concerns that an overzealous Fed will tip the economy into a recession. We expect real GDP to grow by 2.5% this year and by a more trend-line 2.1% in 2020.

### Consumers

Consumer spending came in at a decent 2.5% annualized pace in the fourth quarter, despite a terrifying drop in retail sales in December, which saw the biggest monthly decline since 2009 (-1.6%). Data on the consumer side has trickled in slowly since the start of the year due to the government shutdown, but there are signs that spending growth is slowing. Auto sales fell for two straight months (January and February), retail sales were revised upward in January only to fall by -0.2% in February, and personal income has had a remarkably weak start for the year. The Senior Loan Officer's survey shows a sharp decline in demand for credit related to consumer spending: demand for autos fell by 18.2%, for credit card loans by 17.4%, and for other consumer loans by 14.8%.

The pullback is not unexpected: The stock market plunge in the fourth quarter and the partial government shutdown (the longest in history at 35 days) took their toll on consumer confidence. Moreover, spending likely remained soft at the start of the year since roughly 340,000 furloughed federal workers missed two paychecks. Tax refunds were also processed with considerable delays (due to the shutdown) and the initial reported amount was around 17% below last year's.

**TABLE 2**  
**Economic Dashboard**

	Q3 2017	Q4 2017	Q1 2018	Q2 2018	Q3 2018	Q4 2018	Q1 2019
Capital Goods Orders							
Industrial Production							
Core Retail Sales							
Vehicle Sales							
Existing Home Sales							
Housing Starts							
PMI Nonmanufacturing							
Small Business Sentiment							

However, much of this uncertainty has been resolved: The government reopened at the end of January and tax refunds have almost caught up to previous years. The average refund appears to also be almost unchanged, at least so far. But fewer people are receiving refunds (1.6 million fewer, to be precise), which means that the overall amount of refunds is running below that of 2018 by an estimated \$6 billion. Tax refunds are usually perceived by consumers as an income windfall (forced saving, so to speak) and typically fuel consumer spending on big-ticket durable good items. This may explain why retail sales have been sluggish this quarter.

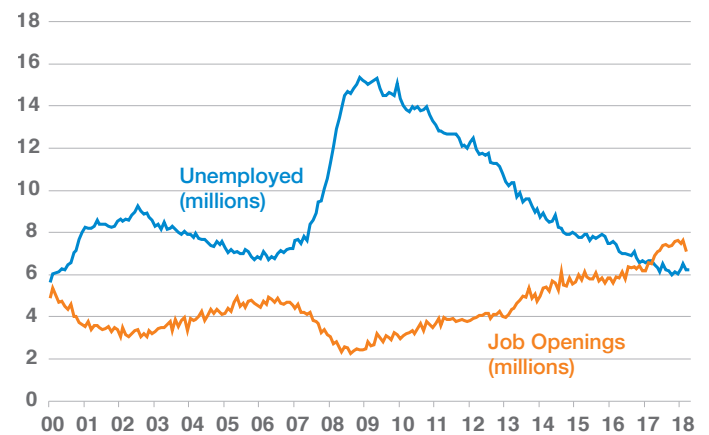
We expect consumer spending to firm up over the remainder of the year, supported by continued employment gains, solid wage growth and improved wealth. The equity market swoon in the fourth quarter of 2018, lopped off an aggregate \$3.7 trillion from household wealth, but much of that has been reversed and wealth should recover in the first quarter. Nonetheless, as the economy progresses through its late stage expansion, we expect growth to moderate in almost all sectors, including consumer spending: We expect consumer spending to grow by 2.5% in 2019, and a more moderate 2.2% in 2020.

### Labor Market

The labor market has had a spectacular run during this expansion, adding jobs for 102 straight months, a historical first. The pace of job formation amped up in 2018, with monthly job gains averaging 222,000, above the 179,000 pace of 2017 and 193,000 of 2016. Unemployment rates ranged between 3.7%-4% throughout the year and even the broader measurement of unemployment (which accounts for those working part time for economic reasons and marginally attached workers) has dipped at the lowest level since records began in 1994. More encouragingly, the labor force for prime-aged workers has swelled by nearly 3 million workers since 2015, a sharp reversal from the headlong decline during the recession and the first few years of the recovery. The job opening rate ramped up and has remained high since mid-2018, marking the highest level since data began in 2000 (Figure 5). The quits rate is also near the top of its historical range, indicating that workers are confident in switching jobs when they wish to.

**FIGURE 5**

**Job Openings Have Moderated But Still Surpass Unemployed Numbers**  
(Unemployed vs. Job Openings, Millions of People)



Data so far this year point to a solid labor market, albeit one that is stepping down a bit from the rapid pace of the past year. The trend was a bit harder to discern, with January posting a blockbuster 312,000 jobs only to be followed by a measly 33,000 in February (revised upward from an abysmal 20,000). We never thought either of these figures reflected the true underlying trend of the economy: The January numbers seem to be inflated somewhat due to some furloughed workers getting part-time work (and thus being double counted) and from an atypically mild weather which boosted employment in retail, construction, and leisure and hospitality. February numbers were plagued by a winter storm in the survey week and a reversal of January's trends.

The March employment report was exactly what was needed to temper fears about an imminent recession and captures, in our view, the true state of the labor market. Job gains were a healthy 196,000, coming above market expectations. However, the overall trend in hiring is easing: The three-month average for payroll growth has slipped to 180,000 in the first quarter from 233,000 in the fourth quarter of 2018. Some sectors performed worse than others: Manufacturing shed more than 6,000 jobs – the first decline in more than 18 months – due in large part to the global slowdown and trade headwinds. Going forward, we expect the labor market to continue to add jobs, albeit at a slower pace than in 2018. We are looking for employment gains of around 170,000 this year and 125,000 in 2020 and for the unemployment rate to average 3.7% in both 2019 and 2020.

### Housing Sector

The housing sector has had a tough couple of years. Real residential construction has fallen for four straight quarters. Builder sentiment collapsed in the fourth quarter and, though marginally improved over the past two months, currently stands at the lowest point since mid-2016. Things turned worse at the end of 2018 and early this year: Housing starts have edged down over the past three months, averaging 1.19 million, below the 1.29 million rate recorded during the first six months of 2018. The most recent figures show a frightening decline of -9.2% on an annualized basis. Home sales saw a year-over-year decline of -10% in December, while home prices have continued to moderate to an annual pace of around 4%.

Unlike the consensus, we expect the housing sector to move from the steady deterioration experienced last year, to modest improvement in 2019. Mortgage rates have fallen by around 50 basis points compared to mid-last year, thanks in large part to improved financial conditions and a dramatic pivot by the Fed to pause its rate-hiking cycle. Signs of improvement have begun to show: Builder sentiment has turned around, mortgage applications have nudged up, existing home sales jumped by 11.2% in February (though they are down compared to year-ago-levels) and buyer traffic has picked up. These developments seem to indicate that a potential thaw is in the cards for housing this year. We expect housing starts to average 1.26 million this year and 1.28 million in 2020, while home prices should rise by an average of 2.5% this year and 2.5% in 2020.

### Business Sector

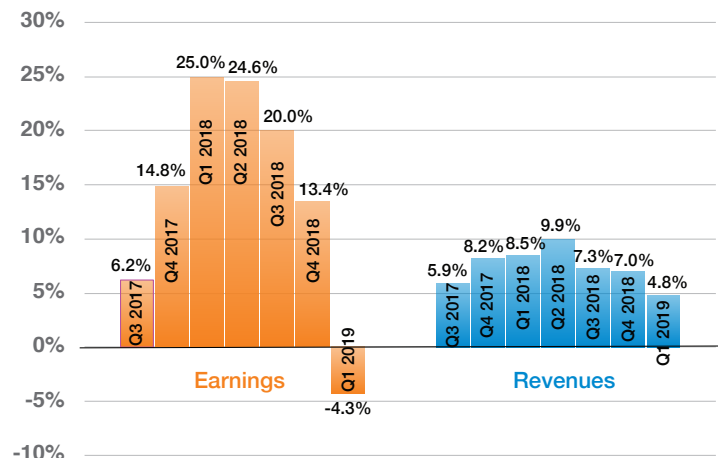
Last year was a tale of two halves for business investments: They rose by an average pace of 7.2% in the first half, but throttled back (at a 2.1% pace) in the second half. This should not come as a surprise: The tax bill passed at the end of 2017 and a solid outlook for growth amped up business spending in the first half of the year. Momentum soured in the last two quarters of the year when trade disruptions began to bite, a slowdown in the global economy came more into focus and the equity market collapse spiked fears of an imminent recession. According to the Duke University Survey released in December 2018, nearly half of CFOs (49%) expected a recession in 2019 and a full 82% in 2020. Small business sentiment slumped to the lowest level in more than two and a half years.

Some of those fears have lifted by now as the most recent data have dispelled concerns that the economy is headed for a recession. Even so, we do expect the business sector to retrench from last year's pace. Manufacturing appears poised for another setback due to slower global growth and concerns

over trade disputes. Worries about potential slow growth and even a recession, have caused businesses to become more cautious. It does not help that weakness in the economy is already beginning to affect the bottom line: In the Wells Fargo Small Business Survey for the first quarter, the number of businesses reporting an increase in revenue over the past 12 months fell sharply, while those reporting declines increased significantly. The gap is still positive (firms reporting increases outnumber those with decreases), but it is narrowing quickly.

All this comes at an inauspicious time for earnings and profits. Corporate profits surged in 2018 on the back of the historic corporate tax cut and strong fundamentals. These factors no longer pack the same punch as they did last year. Couple this with rising costs and wage bills and it does not take long to conclude that profit growth is likely to have already peaked (Figure 6). This will likely weigh on business decisions for hiring and capital spending. We expect business fixed investments to grow by 4.1% this year and 3.3% in 2020.

**FIGURE 6**  
Corporate Profits and Earnings Are Past Their Peak  
(Percent Change, Quarter-over-quarter, Annualized)



### Risks: A More Fragile Outlook

*"The night is dark and full of terrors"*  
-Game of Thrones

As the expansion approaches its 10th birthday, making this the longest expansion in the books, risks and vulnerabilities have increased. There are four main risks that we foresee over the forecast horizon that could derail growth and deliver a worse outlook than our baseline scenario.



First, slower growth presents its own risks, as the economy is not as resilient and may succumb to the weight of all sorts of shocks. Soft landings have been rare historically, but whenever they occurred they coincided with an easing of interest rates which lengthened the expansion and contributed to a subsequent pick-up in economic activity.

This brings us to the first source of risk: monetary policy. The Fed has dramatically changed its policy stance this year, shifting from three rate hikes in 2019 to being on hold and announcing a much-earlier than anticipated end to the shrinking of its balance sheet. While welcome, these moves may not be enough, and a rate cut might be needed to boost economic growth and help extend the life of this expansion.

This is not unprecedented: The Fed has lowered interest rates three times during an expansion (in 1967, 1985 and 1995-1996). All three cycles ended up being the three longest expansions in a post-war era. The risk is that, with the latest data firming, the Fed will likely opt to keep its current rate pause in place. In addition, it may also want to resist rate cuts in order to more firmly assert its independence now that it is being tested by an administration clamoring for rate cuts. Mixing politics and economics is never a good idea and is an especially dangerous recipe in the world of central banking. Our view is that the Fed will be on hold this year and lower rates early next year, waiting for fairly conclusive evidence of economic weakness before cutting rates. The risk is that by then, it may be too late to save this expansion.

The second source of risk is fiscal policy. A number of deadlines loom large: the debt ceiling was suspended until March 1, but that suspension has run out and a new authorization is needed. Through extraordinary measures, the Treasury might be able to make do until August, but by then a full agreement (or another suspension) is needed. On the spending side, the latest two-year deal, which lifted the budget spending caps by around \$300 billion, expires in October. If Congress does not reach another deal by then, the sequester (spending limits agreed to back in 2011) would kick back in, reducing fiscal discretionary spending by \$125 billion (10%) from current levels. If you are looking for an exogenous shock to snuff the life out of this expansion, this would be it.

Another source for concern, which has marred the outlook for quite some time, is the U.S.-China trade talks. By all accounts the talks are progressing swimmingly, but risks remain. First, the fourth round of talks just concluded and no deal is yet in place. Without a clear deadline, the discussions could

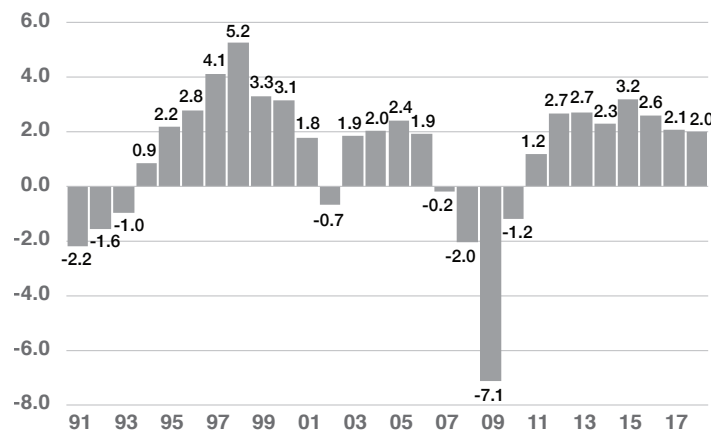
drag on and even stall. More importantly, the two sides have agreed on what appear to be low-hanging fruits (currency manipulations and the amount of U.S. goods China will commit to purchase). Thornier issues are still to be tackled: Forced technology transfers from U.S. firms, wide-scale subsidies and inadequate protection of intellectual property rights. The goal for the Chinese delegation is much simpler and consists on lifting tariffs on roughly 44% of Chinese exports to the U.S. However, tariffs are viewed by the administration as a means of leverage and enforcement, and ironing out details on how to lift them is part of the ongoing negotiations. The markets appear to be patient for now, but should a deal drag out much longer or if negotiations break up with no agreement in place, it would not take long for panic to set in.

Lastly, market performance has been spectacular and volatility quite quiescent in the first quarter of the year, despite a backdrop of weakening fundamentals and slower global growth. This is surprising given that the economic and political landscape was as fluid in the first quarter as back in the fourth quarter of 2018, when equity markets collapsed by nearly 20%. The only change was the dramatic shift in monetary policy, both in the U.S. and Eurozone, with both central banks assuming a notably more dovish stance. Ample liquidity can deliver positive results but only up to a point, especially given current (high valuation) levels. If growth slows materially more than envisioned in our baseline outlook, it is wise to prepare for higher volatility and uncertain returns. The road ahead can indeed get bumpier!

## ORANGE COUNTY AND SOUTHERN CALIFORNIA OUTLOOK

Orange County continued to enjoy robust job growth during 2018. In line with the national picture, the county added 32,300 jobs in 2018 (a 2% increase), compared to a revised increase of 32,700 jobs (2.1%) in 2017 and a 2.6% increase in 2016 (Figure 7). The biggest gainers were in the following sectors: Professional & Business Service, (12,500) for a 4.1% increase; Education & Health Services, (9,600) constituting a 4.2% increase, Leisure & Hospitality Services, (4,500) for a 2.1% increase, and Construction (4,300) for a 4.2% increase. Job growth in the Professional & Business Services sector jumped in 2018 compared to 2017, from 1.7% to 4.1%, while Education & Health Services eased from 4.7% to 4.2%. Other major sectors also showed some moderation: The pace of job formation for the Leisure & Hospitality sector decelerated from 2.9% to 2.1%, while for Construction it edged down from 4.5% to 4.2%. While the annual rate of total employment growth for the county slowed slightly in 2018 compared to the previous two years, it still is higher than its 20-year annual average of 1.5%.

**FIGURE 7**  
**Robust Job Growth in Orange County**  
(Employment Growth, Year-over-year Percent Change)



The data for the early months of 2019 paint a much more concerning picture, with job growth coming to a virtual stall. However, given the Employment Development Department (EDD) record for the last two years, we need to take these numbers with a grain of salt. Early-year weak job numbers have eventually been revised substantially higher for a number

of years now. Indeed, the EDD had to revise Orange County's payroll employment numbers significantly upward in the March benchmark revision in 2017 and 2018, as discussed later in this report. It appears that they will have to do that for the 2019 data as well.

The average annual rate of unemployment in Orange County fell to 2.9% in 2018 compared to 3.7% in 2017 and 4% in 2016. This happened in spite of a growing labor force (more people joining the job market either working or looking for a job). The labor force grew by a robust 24,500 in 2018 compared to an increase of 19,300 in 2017. The labor force stood at 1,649,300 in 2018, a level higher than prior to the Great Recession.

The overall labor market picture looks equally upbeat for the state. California added 338,500 jobs in 2018, an increase of 2% compared to a revised number of 356,000 (2.2%) in 2017 and 428,000 (2.7%) in 2016. While growth is certainly moderating, this is still above the 20-year average of 1.3% for the state. This indicates continued recovery of the state's economy from the Great Recession. The state unemployment rate fell to 4.2% in 2018 from an average of 4.8% in 2017, the lowest in more than 30 years.

Southern California job growth has also held up quite well. The counties of Orange, Los Angeles, Riverside, San Bernardino, Ventura and Imperial together added 147,200 jobs, a 1.9% increase in 2018 compared to 1.9% growth in 2017 and 2.7% in 2016. The 20-year average rate of growth for the region is 1.2%. The average unemployment rate for the region fell to 4.3%, the lowest since 2006.

Los Angeles County employment in 2018 grew by 61,800 (1.4%) compared to 53,000 (1.2%) in 2017 and 2.5% in 2016. Education & Health Service employment grew by 23,000 jobs at a rate of 2.9% compared to 3.6% growth in 2017; Professional & Business Services employment increased by 11,200 (1.8%) compared to a rate of 1.5% in 2017. Construction employment growth jumped by 7,600, growing by 5.5% in 2018 from 3.3% in 2017, while the growth rate in Leisure & Hospitality fell to 1.8% from a 2.9% rate in 2017. Los Angeles County's unemployment rate averaged 4.7% in 2018, compared to 4.8% in 2017 and 5.5% in 2016.

The Inland Empire, made up of Riverside and San Bernardino counties, grew at a slightly slower rate last year relative to 2017, adding 49,300 new jobs (a 3.4% increase) compared to a gain of 515,000 (3.7%) in 2017. Employment in the Construction

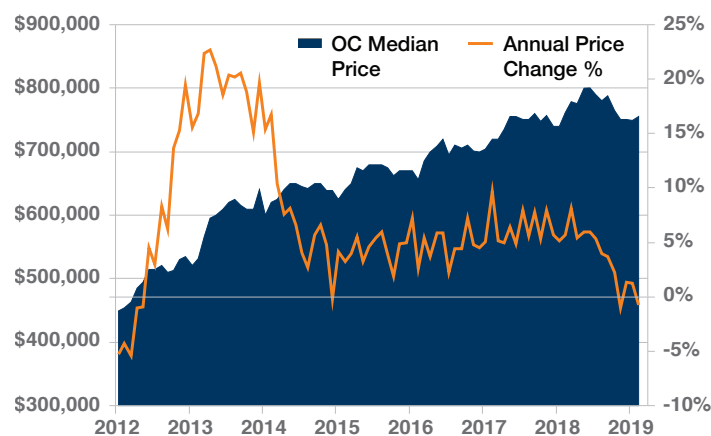
sector grew by a jaw-dropping 7.6% in 2018, up from a solid 5.9% in 2017. Job gains also occurred in other larger sectors, such as Trade, Transportation & Utilities (up by 12,800 for a 3.5% increase in 2018 compared to 5.1% in 2017), Professional & Business Services (up by 3,800 or 2.6% versus a gain of 1.4% in 2017). The average unemployment rate in the region fell to 4.2% in 2018 from 5.1% in 2017 and 6% in 2016.

The overall job market picture for 2018 has been one of continuing growth in all the counties of the Southern California region if at a slightly slower rate than in 2017.

## Orange County Housing

Home prices continued to rise in 2018, albeit at a slower clip, reversing the devastating losses of the Great Recession. Indeed, median prices set records in the region. The median single-family home price in Orange County appreciated by 4.3% in 2018, following a 6.4% increase in 2017. The increases for Los Angeles, Riverside and San Bernardino counties were, respectively, 6.4%, 6.9% and 7.9%, slightly lower than the 2017 rate when home prices grew by 7.6%, 9.1% and 7.9% (Figure 8). The median price in Orange County averaged \$773,000 in 2018. Median prices in Los Angeles, Riverside and San Bernardino counties were \$622,000, \$381,000 and \$310,00.

**FIGURE 8**  
**Orange County Median Home Prices**  
(Level and Percent Change)



Home sales, on the other hand, have been rather dismal due to lack of supply. Sales volume in Orange County declined by 8.9% in 2018. The trend has worsened this year as home sales dropped by 16% during the first two months of 2019 compared to the same period in 2018. The story is very similar in other parts of Southern California and indeed in the nation. The culprits appear to be the high cost of construction and low affordability. Thus, it is not surprising to see that solid home price growth has continued through 2017 and 2018 even though the rate of appreciation is cooling off.

Construction activity has slowed in Orange County. Construction permits fell to 8,200 in 2018, compared to 9,500 in 2017, a decrease of 13.7%. For the Southern California region, permits were down by 3.9%. However, there are regional differences: For example, the number of permits in the Inland Empire was unchanged in 2018 from 2017, while they were slightly higher for Los Angeles County. While most of the future growth in construction will be coming from the Inland Empire and Los Angeles County, the current trends indicate slowing growth in the near future. Construction permits for Orange County are expected to settle around 7,500 in 2019, which is the average rate of permits for the past 20 years.

The expectation that the Federal Reserve is on pause and will not raise interest rates in 2019 has caused mortgage rates to decline by an average of around 50 basis points. As of March 2019, the 30-year fixed term mortgage rate stands at 4.27%, or 20 basis points below that of January 2019 and the lowest since January 2018. While this will help sales somewhat, and the summer months are always more active, the maturing economy and continued high home prices that pinch affordability will keep home sales lower than in recent years. We expect median home price in Orange County to increase by 1.5%-2.5% during 2019 and by a similar amount in 2020.

## Tariffs and Trade – Impacts on Southern California

On September 24, 2018, the last round of U.S. tariffs on \$250 billion of Chinese imports took effect. Trade data from the last three months of 2018, when the tariffs were in full effect, show the United States imported fewer tariffed products from China, but overall imports of products rose as exports to China fell substantially. According to analysis conducted by the Woods Center, the impact of these tariffs on Southern California is similar to that for the country as a whole (full report available from the center).

Imports from China rose by 6.9%, while imports from the rest of the world grew by 9.1%. Imports of tariffed products from China declined by 2.1%. But imports of products not tariffed rose by almost 13%, leading to the overall rapid growth of imports from China.

The impact of Chinese retaliatory tariffs on American exports are difficult to track as the list of products that China tariffs does not match with the classification of American exports

in the census trade data. But U.S. exports to China declined 31.4% from \$39.3 billion to \$27 billion between the last three months of 2017 and 2018, which has led to a 16.2% increase in the U.S. trade deficit in goods with China over that time period. Some of this decline in exports is due to the retaliatory tariffs that China placed on most American exports.

But retaliation does not account for all of the widening of the trade deficit, as other events have likely contributed to the increase in the trade deficit with China. The dollar appreciated versus the Chinese yuan by 4.6% between the last three months of both 2017 and 2018, which would make Chinese products cheaper for American consumers and American products more expensive for Chinese consumers. Also, U.S. economic growth continued to be strong in 2018, which promoted strong consumer spending and import growth, while slowing Chinese growth contributed to reduced demand for American exports.

**TABLE 3**  
Imports into Southern California by Country and by Tariff Status

Imports into Southern California	IMPORTS FROM CHINA (Billions of Dollars)		
	Not Tariffed	Tariffed for China	Total
Last Three Months of 2017	24.4	15.9	40.3
Last Three Months of 2018	27.5	15.6	43.1
Percent Growth	12.8%	-2.1%	6.9%
Imports into Southern California	IMPORTS FROM THE REST OF THE WORLD		
	Not Tariffed	Tariffed for China	Total
Last Three Months of 2017	14.9	25.8	40.7
Last Three Months of 2018	16.0	28.4	44.4
Percent Growth	7.3%	10.1%	9.1%

## Regional Outlook and Forecasts

In order to develop reliable forecasts, one should have multiple sources of information. This is especially true when the historical data are subject to error, as was the case with the official state data for 2017 and 2018, provided by the EDD. For example, for our October 2018 forecast, data through August 2018 was available, which was significantly revised in March 2019 during the benchmarking process.

**TABLE 4**  
**Employment Benchmark Revisions**  
(Data through Aug. 2018)

		2018	Change from Prior Year	
			Level	%
<b>Orange County</b>	Benchmark Data	1,642,363	25,338	1.5%
	Previous Estimate	1,627,050	10,492	0.6%
<b>Los Angeles County</b>	Benchmark Data	4,487,900	39,642	0.9%
	Previous Estimate	4,471,238	35,588	0.8%
<b>Riverside County</b>	Benchmark Data	1,493,750	38,850	2.6%
	Previous Estimate	1,487,713	36,104	2.4%

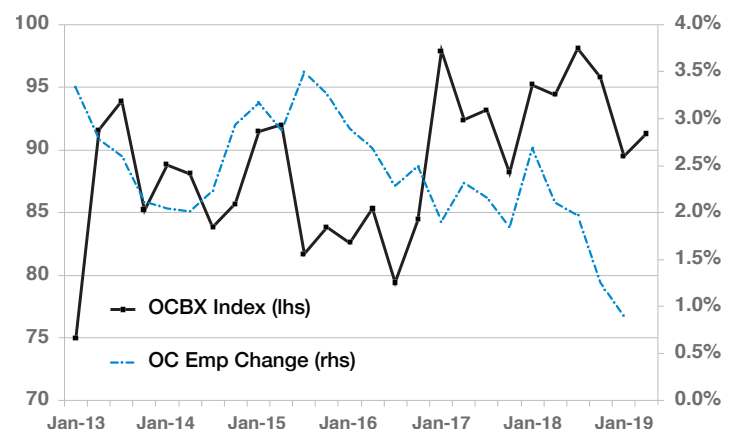
The correction was especially large for Orange County, which played into the fall forecasts. The data available in August 2018 (which fed into our fall forecast models), showed an average annual increase of 10,492 jobs (compared to the same period in 2017), representing a mere 0.6% increase. But the actual increase revised in the benchmarking process (released in March 2019) was 25,338. This means that Orange County's labor market was growing at a much faster rate than what the official data releases were picking up; the monthly EDD data releases missed almost 15,000 jobs actually created in the county during the first eight months of 2018. Similar but much smaller errors were present in the data for Los Angeles and Riverside counties and other parts of the state. Such errors affect the accuracy of forecasts which tend to rely significantly on recent trends.

In addition to the major role of past employment trends, an indicator for the local economy is local business leaders' expectations of growth. The Woods Center conducts a

quarterly survey of business leaders' expectations of their own firm's growth and the growth of the local economy. The center calculates an overall measure, the OCBX Index, which is a combined score of leaders' expectations of their assessment on future growth for their own business and for the local economy. The index is correlated with the trend in local economic conditions, including job growth, and has proven to be a good indicator of future growth.

The OCBX index for the second quarter of 2019 stood at 91.3, a reading above that of the first quarter of 2019 (Figure 9). This was a small uptick after two consecutive declines in the second half of 2018. Yet the value of the index is below that reached at the beginning of 2018.

**FIGURE 9**  
**Orange County OCBX Index and Employment Change**  
(Index Level and Employment Year-over-year Percent Change)



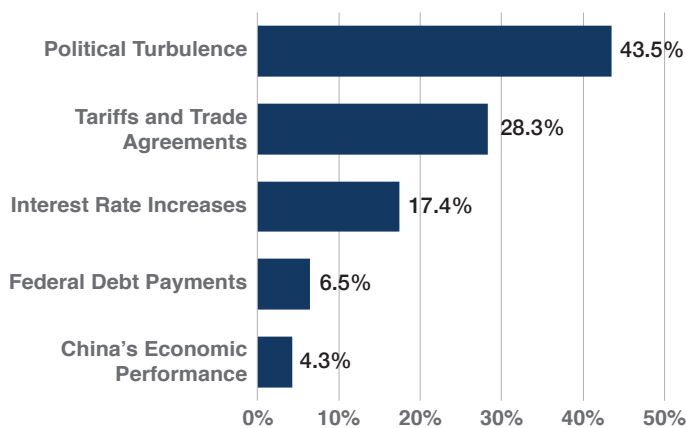
Business executives identified several factors as being significant to the expected future performance of their companies. After two quarters, the state of the economy again ranked as the top issue in the second quarter of 2019. Government regulation continued to be a close second. Labor costs stayed as the third most important issue followed by international competition and taxes.

When asked about threats to their businesses, the Orange County executives listed political turbulence, which is not surprising given the government shutdown in February and



ongoing political squabbles in Washington (Figure 10). Tariffs were the second most important concern as talks with China are still far from complete while trade relations with Europe and other regions remain uncertain. The third most important reason cited was possible interest rate increases by the Federal Reserve. However, this risk factor has diminished significantly following multiple indications from the Fed that it doesn't plan to raise rates for the rest of this year. Federal debt was the fourth most significant threat cited by the business executives.

**FIGURE 10**  
**Biggest Threat to the U.S. Economy**  
(OCBX Index, 2nd Quarter 2019)

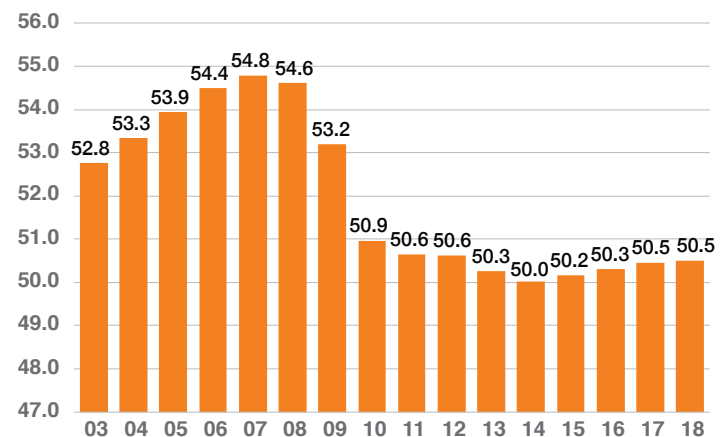


Answers to other questions on the survey showed a general softening of the business optimism compared to the last two quarters: Profit expectations were lowered and hiring decisions pulled back somewhat. The survey also showed low expectations of a recession in 2019, a less than 20% chance. This is consistent with our projections as discussed in our national economy segment above.

While Orange County's unemployment rate is at a historic low, similar to that of the nation, and labor markets are getting tighter, there is still room for employment to grow. The Great Recession sidelined a large number of working people. While the recovery has brought many of them back to the labor force, there are still many who have yet to make that decision. Labor force participation rate in the county dropped from 54.7% in 2004 to 50% in 2014 (Figure 11). While it has crept up to 50.5% in 2018, there is room for further improvement. A one percent improvement in the county's labor force adds approximately 15,000 people to the workforce. So, if the participation rate were to get to the pre-recession level, more

than 60,000 workers could be added to the labor pool. At the current clip, this should take an additional couple of years, potentially extending the life of this expansion.

**FIGURE 11**  
**Orange County Labor Force Participation Has Room to Grow**  
(Labor Force Participation Rate)



Our forecasts for employment growth as outlined in Figure 12 are derived from the econometric models that we maintain, surveys of the Woods Center as well as other available information that impacts our region. Employment is expected to continue to increase in Orange County and the region but at a slower rate over this year and the next.

**FIGURE 12**  
**Payroll Employment Forecasts**  
(Annual Percent Rates)

